H Encycopedia , Inc.

FMAA ماتريال شهادة

ARABFMAA

Section E

Cost Management concepts

2024

fmaa™

Financial & Managerial Accounting Associate

Telegram & Facebook
ARABFMAA

Section E: Professional Ethics (10%)

Study Unit 37: E.1. Business Ethics

The topic *Professional Ethics* represents 10% of the FMAA exam.

Professional ethics are tested in two arenas:

1) Business ethics.
2) Ethical considerations for management accounting and financial management professionals.

Introduction

Businesses do not exist in a vacuum, but they do operate in the social and political world of engagement, interaction, and competition between and among people and other companies. Business decision-making is not simply a matter of abstract equations and algorithms. Rather, businesses function in an environment where choices affect real lives, livelihoods, the physical environment, and the social and economic wellbeing of others. As such, businesses operate within a framework of moral and ethical choices, and people engaged in business are frequently confronted with moral and ethical dilemmas. When the foremost imperative is the protection and longevity of a company, the expansion of its market share, and the happiness of investors, relatively simple choices can become more complex, murkier, and less about ideals and more about practicality. For example, if an accountant's immediate superior instructs the accountant to maintain the valuation of the physical inventory at its original cost when it is obvious that the value of the inventory is reduced due to obsolescence, what should the accountant do?

In a broader sense, ethics deals with human conduct in relation to what is morally good and bad, or right and wrong. However, to determine whether a decision is good or bad, the decision-maker must judge the available options against an external standard or framework. Such standards can be rigid or flexible, providing either strict or adjustable guidelines. Laws, codes of professional conduct, personal codes of conduct, religious teachings, philosophical tenets, and social norms are all forms of moral frameworks that can aid a decision-maker in making a choice when faced with an issue that has no clear-cut answer.

Ethics is the set of moral principles or values that drives behavior and the decisions an individual makes. Ethics consists of the standards of conduct that originate from a group or a society. What is considered ethical behavior is governed by the values of a group and may be expressed as principles, standards, and codes.[89] Because what is ethical in any given group depends on that group's standards, any code of behavior—even if it does not claim to have moral justification—can be considered ethics.[90]

> **Note**: Ethics is also defined as "the application of values to decision making. These values include honesty, fairness, responsibility, respect, and compassion."[91]

Business ethics is a field of study that analyzes the practices within organizations to determine whether they are acceptable. Business ethics is also a set of principles or a code of conduct by which business activities are judged to be appropriate or questionable.[92]

---

[89] Archie B. Carroll, Jill A. Brown, and Ann K. Buchholtz, *Business and Society: Ethics, Sustainability, and Stakeholder Management*, 10th ed. (Boston: Cengage Learning, Inc., 2018), 190.

[90] *Values and Ethics: From Inception to Practice*, Statements on Management Accounting (Montvale, NJ, Institute of Management Accountants, 2014), 25 (Glossary).

[91] Rushworth Kidder, Institute for Global Ethics, quoted in *Values and Ethics: From Inception to Practice*, Statements on Management Accounting (Montvale, NJ, Institute of Management Accountants, 2014), 2.

[92] Carroll, Brown, and Buchholtz, 190.

Thus, business ethics is a systematic study of the organizational principles, values, and norms guiding individual and group behavior in business as provided by individuals, organizational policy statements, and the legal systems the business is subject to.[93]

- **Principles** are specific boundaries for behavior that should not be violated, such as human rights, freedom of speech, and fundamentals of justice. Principles are often the basis for rules.
- **Values** are beliefs and ideals that are socially enforced. Positive values such as teamwork, trust, and integrity are often based on best practices within the organization or industry.[94] The values of an individual reflect what the individual considers important in the larger scheme of things.[95]
- **Norms** are standards of behavior that are judged to be proper and acceptable.

Ethics should be formally incorporated into an organization's culture as part of the company's code of conduct. It should also be incorporated into the organization's culture informally, such as through peer pressure or the tone set by the management team. By establishing corporate ethical standards, organizations endeavor to influence the behavior of their managers and employees and to communicate a sense of the organizations' values to their current and potential customers.

In practical terms, business ethics standards distinguish between desirable and undesirable behaviors and actions in relation to the following and other considerations:

Section E: Professional Ethics (10%)

Study Unit 37: E.1. Business Ethics

The topic *Professional Ethics* represents 10% of the FMAA exam.

Professional ethics are tested in two arenas:

1) Business ethics.
2) Ethical considerations for management accounting and financial management professionals.

Introduction

Businesses do not exist in a vacuum, but they do operate in the social and political world of engagement, interaction, and competition between and among people and other companies. Business decision-making is not simply a matter of abstract equations and algorithms. Rather, businesses function in an environment where choices affect real lives, livelihoods, the physical environment, and the social and economic wellbeing of others. As such, businesses operate within a framework of moral and ethical choices, and people engaged in business are frequently confronted with moral and ethical dilemmas. When the foremost imperative is the protection and longevity of a company, the expansion of its market share, and the happiness of investors, relatively simple choices can become more complex, murkier, and less about ideals and more about practicality. For example, if an accountant's immediate superior instructs the accountant to maintain the valuation of the physical inventory at its original cost when it is obvious that the value of the inventory is reduced due to obsolescence, what should the accountant do?

In a broader sense, ethics deals with human conduct in relation to what is morally good and bad, or right and wrong. However, to determine whether a decision is good or bad, the decision-maker must judge the available options against an external standard or framework. Such standards can be rigid or flexible, providing either strict or adjustable guidelines. Laws, codes of professional conduct, personal codes of conduct, religious teachings, philosophical tenets, and social norms are all forms of moral frameworks that can aid a decision-maker in making a choice when faced with an issue that has no clear-cut answer.

Ethics is the set of moral principles or values that drives behavior and the decisions an individual makes. Ethics consists of the standards of conduct that originate from a group or a society. What is considered ethical behavior is governed by the values of a group and may be expressed as principles, standards, and codes.[89] Because what is ethical in any given group depends on that group's standards, any code of behavior—even if it does not claim to have moral justification—can be considered ethics.[90]

Note: Ethics is also defined as "the application of values to decision making. These values include honesty, fairness, responsibility, respect, and compassion."[91]

Business ethics is a field of study that analyzes the practices within organizations to determine whether they are acceptable. Business ethics is also a set of principles or a code of conduct by which business activities are judged to be appropriate or questionable.[92]

---

89 Archie B. Carroll, Jill A. Brown, and Ann K. Buchholtz, *Business and Society: Ethics, Sustainability, and Stakeholder Management*, 10th ed. (Boston: Cengage Learning, Inc., 2018), 190.

90 *Values and Ethics: From Inception to Practice*, Statements on Management Accounting (Montvale, NJ, Institute of Management Accountants, 2014), 25 (Glossary).

91 Rushworth Kidder, Institute for Global Ethics, quoted in *Values and Ethics: From Inception to Practice*, Statements on Management Accounting (Montvale, NJ, Institute of Management Accountants, 2014), 2.

92 Carroll, Brown, and Buchholtz, 190.

Thus, business ethics is a systematic study of the organizational principles, values, and norms guiding individual and group behavior in business as provided by individuals, organizational policy statements, and the legal systems the business is subject to.[93]

- **Principles** are specific boundaries for behavior that should not be violated, such as human rights, freedom of speech, and fundamentals of justice. Principles are often the basis for rules.
- **Values** are beliefs and ideals that are socially enforced. Positive values such as teamwork, trust, and integrity are often based on best practices within the organization or industry.[94] The values of an individual reflect what the individual considers important in the larger scheme of things.[95]
- **Norms** are standards of behavior that are judged to be proper and acceptable.

Ethics should be formally incorporated into an organization's culture as part of the company's code of conduct. It should also be incorporated into the organization's culture informally, such as through peer pressure or the tone set by the management team. By establishing corporate ethical standards, organizations endeavor to influence the behavior of their managers and employees and to communicate a sense of the organizations' values to their current and potential customers.

In practical terms, business ethics standards distinguish between desirable and undesirable behaviors and actions in relation to the following and other considerations:

- A general understanding of what is right and wrong
- Compliance with laws and regulations, both external and internal
- Resolution of conflicts
- Conflicts of interest
- Whistleblowing
- Bribes and kickbacks
- Social responsibilities, or how the entity relates to its communities, the environment, and society

Note: A **conflict of interest** is a situation in which a public official, business executive, or other individual in a position of trust might receive personal gain for him- or herself or for a friend or family member from his or her official or professional actions.

A **whistleblower** is a person who reports wrongdoing or corruption. This includes concerns about safety, financial fraud, mistreatment of employees, or other improper actions. The report might be made to an entity either internal or external to the organization and is typically done anonymously or confidentially.

A **bribe** is something that is given or offered to a person or organization in a position of trust to induce that agent to behave in a manner inconsistent with that trust.[96]

---

[93] O. C. Ferrell, John Fraedrich, and Linda Ferrell, *Business Ethics: Ethical Decision Making and Cases*, 12th ed. (Boston: Cengage Learning, Inc., 2019), 4.

[94] O. C. Ferrell, Fraedrich, and L. Ferrell, 4-5.

[95] Carroll, Brown, and Buchholtz, 213.

[96] *Values and Ethics: From Inception to Practice,* Statements on Management Accounting (Montvale, NJ, Institute of Management Accountants, 2014), 24-26 (Glossary).

Despite the existence of laws, codes, regulations, and social mores, there will always be numerous external and internal factors that encourage unethical behavior. These various factors may lead, in certain cases, to behaviors that contradict individual and corporate ethical standards.

1) **Individual level**. Employees come from a wide range of backgrounds and bring to the work environment their own motivations and desires. Therefore, people have varying levels of susceptibility to temptation and unethical behavior. As a result, individuals will react differently when presented with the same situations. Some may take advantage of an unethical scenario whereas others will steer clear.

2) **Organizational level**. The culture of an organization sets the tone for the way in which unethical behaviors are handled. Management style, group dynamics, compensation or promotion systems and practices, performance evaluation, budgeting, reporting processes, and the overall condition of the business are all important factors that can prompt an individual to either engage in ethical lapses or avoid them. In most instances, management sets the example for employees to follow. If it becomes clear to the staff that unethical behavior is tolerated or even rewarded, such behavior will become the norm in the workplace.

3) **Outside the organization**. External pressures and influences, such as those from competitors, investors, partners, customers, governments, and other stakeholders may compel individuals to compromise their ethical standards. A firm doing business in multiple countries or cultures may find it particularly difficult to have all employees adhere to a single set of rules and reach consensus on what should be considered right or wrong as applied to business practices.

The values of an individual shape the individual's ethics, and the values of an organization's leaders shape the organization's ethics.

Within any company or industry, different groups may have different ethics because the applicable values for each group are different. For instance, business ethics in accounting is different from business ethics in engineering, and both are different from business ethics in marketing. Business ethics includes all the behaviors or decisions made in business by groups of people representing the organization.

Any corporate culture has rules and regulations that determine what decisions the members of the group consider to be right or wrong. The rules and regulations may be written or unwritten. An organization's business ethics are the **judgments made by the organization**. In business ethics, right and wrong behavior **is defined by the group**, and the group might be a company or a whole industry.[97]

An **ethical decision** is one for which the accepted rules do not provide an answer, and the decision-maker must weigh values and reach a judgment in an unfamiliar situation. In making ethical decisions, decision-makers must use their own values as well as accepted practices within the organization. Thus, values and judgments play a critical role in making ethical decisions.[98]

Values for Ethical Decision Making

An ethical decision is one for which the accepted rules do not provide an answer, and the decision maker must weigh values and reach a judgment as to how to proceed. If a rule exists for handling the situation—for example, employees do not accept gifts from vendors or customers—the course to be followed is clear. The question of what to do arises when no stated rules exist that cover a specific situation. In those situations, decision-makers must use their own values along with accepted practices within the organization.

Fairness, integrity, due diligence, and fiduciary responsibility are some of the considerations in making ethical decisions.

[97] O. C. Ferrell, Fraedrich, and L. Ferrell, 5.
[98] O. C. Ferrell, Fraedrich, and L. Ferrell, 5.

Fairness

Fairness means acting in a manner that is free from bias,[99] dishonesty, or injustice. It is the quality of being just, equitable, honest, and impartial. Three fundamental elements are involved in fairness: equality, reciprocity, and optimization.

- **Equality** in business refers to fair distribution of benefits and resources, either to stakeholders or to the greater society.
- **Reciprocity** refers to an interchange of giving and receiving. It means an action that affects another entity is reciprocated by that other entity with an action that has approximately the same effect. Compensating employees with wages that are approximately equal to the value of their work is an example of reciprocity.
- **Optimization** in hiring or in selecting students means choosing the most qualified person, that is, the most talented, proficient, educated, and able person. The use of any basis other than qualifications to select an employee or a prospective student is unfair because any other basis—such as gender, race, or religion—has no bearing on a potential employee's ability to do a job or a potential student's ability to succeed in a course of study.[100]

Integrity

A recent global survey by the Conference Board[101] asked senior management and board chairs to identify leadership attributes and behaviors they considered critical to future success. The top attribute was integrity. Integrity means being honest and upstanding and adhering firmly to a code of values. The actions of persons or firms that have integrity are consistent with their principles. People and firms demonstrate consistency by not compromising their core values even under strong pressure.[102]

Conflicts of interest are important obstacles to having integrity and making ethical decisions. A conflict of interest would tend to make a decision-maker's independent judgment less reliable in that situation than it normally would be, as it could influence the decision-maker to make a decision that may not be in the best interest of those who are relying on that judgment.

A director, a manager, or an employee of an organization is expected to make judgments and decisions that are in the best interests of the organization and its shareholders. An accountant is expected to make judgments that are in the public interest.

If the decision-maker knows about a conflict of interest or even if the decision maker **should have known** about the conflict of interest but does not tell the party on behalf of whom he or she is exercising judgment, then the decision-maker is perpetrating a deception.

The **appearance** of having a conflict of interest can be as harmful to the decision-maker's reputation as having a **real** conflict of interest. Any conflict of interest must be recognized and dealt with immediately, whether it is real or apparent and whether there is or is not any potential for harm, or whether harm has already occurred. Action must be taken to avoid or manage the harm and to ensure that the actions that are taken are seen as ethically responsible.

---

[99] Bias is an inclination that influences one's judgment. *Values and Ethics: From Inception to Practice*, 24 (Glossary).

[100] O. C. Ferrell, Fraedrich, and L. Ferrell, 60.

[101] According to its website at www.conference-board.org, The Conference Board is an international, not-for-profit, business membership and research association organized in the State of New York, U.S.A. Among many other scientific, educational, and charitable activities and publications, it researches and publishes economic information such as business cycle indicators for major economies around the world. It also publishes the U.S. Consumer Confidence Index.

[102] Brooks and Dunn, 169.

Example: A purchasing manager who has authority to make purchases has a responsibility to exercise judgment and purchase not only the lowest-priced item but the item that is of acceptable quality and the best value for the price. One of the bidders for an upcoming purchase is the purchasing manager's brother-in-law.

Because of the purchasing manager's family relationship with the brother-in-law, the purchasing manager has a conflict of interest. Even if the best value for the price with acceptable quality is offered by the purchasing manager's brother-in-law, the purchasing manager should recuse himself or herself from the decision-making process for this purchase.

Considerations in managing conflicts of interest in decision making should include the following.

1) **Avoidance** is the preferred approach if it is possible. A decision maker with a conflict of interest should step aside and let another person make the decision, known as **recusing** himself or herself.

2) **Disclosure** of any potential conflict of interest to stakeholders who are relying on the decision may be necessary.

3) **Management** of the conflict may also be considered if avoidance is not possible, including:

   - Ensure that all employees are aware of the potential for a conflict of interest such as gifts they might be offered by a customer.

   - Have a code of conduct and related training for how to handle such situations.

   - Rules against receiving gifts or kickbacks should be in place. If there are any situations in which it may be acceptable to give or accept a small gift, guidelines should specify those situations and the size of gift that may be acceptable.

   - Create an understanding of the reasons why the company cannot have unmanaged conflicts of interest, why the guidelines have been developed to prevent their occurrence, to require their reporting if they have occurred, and what the penalties are for failure to report.[103]

Note: The responsibility to make decisions with **integrity** requires a decision-maker who has a conflict of interest in a decision situation to recuse himself or herself from any part of the decision process.

Due Diligence

Due diligence literally means "requisite effort." In a legal context, it means "the care that a reasonable person takes to avoid harm to other persons or their property." When used in a business context, it refers to research done before engaging in a financial transaction to avoid harm to either party. The research includes investigation to confirm representations made by the other party and possibly to locate information not provided in the other party's representations. Due diligence involves examining the other party's financial position, business record, and anything else deemed material to the transaction.

Growing pressure on firms to show that they behave responsibly has added the necessity to determine whether the other party's ethics are sound, whether its values are compatible with the firm's own, and whether the transaction would pose risks to the reputation of the firm doing the research.[104] Furthermore, the behavior of the other party could pose legal risks to the firm, because under certain circumstances, a firm can be held legally responsible for actions of a business partner, for example where violations of the Foreign Corrupt Practices Act (FCPA) are involved.[105]

---

[103] Brooks and Dunn, 257-260.

[104] David Lascelles, *Ethical Due Diligence: An Introduction and Guide, Executive Summary,* (London: The Institute of Business Ethics, 2007), 7.

[105] Ingram, Audrey, Partner, Richards Kibbe & Orbe, LLP. *Mitigating FCPA Risks in Corporate Transactions.* Alta Claro video, 58:29. September 27, 2017.

Thus, the concept of "ethical due diligence" is an extension of traditional due diligence. Ethical due diligence is required in many different types of circumstances.

- A company that is entering into a business combination, partnership, or joint venture needs to ensure that the corporate culture and ethical values of the other party will match their own.
- When appointing agents and suppliers, a company should ensure that those agents and suppliers have values that match those of the company.
- Prior to making a loan, a lender should confirm that the proceeds from the loan will be used for ethical and legal activities.
- When recruiting employees and directors, the company should ensure that the individuals have personal values and ethics that are very similar to those of the company.
- Likewise, individuals who are recruited to work at a company should do ethical due diligence on their prospective employers to make certain that there is an ethical fit.

Fiduciary Responsibility

A fiduciary is a person or an entity to whom assets or authorities have been entrusted so the fiduciary can manage them for the benefit of another entity or entities. A fiduciary is responsible for acting in the best interests of those other entities, called the principals or beneficiaries. In business, the term "fiduciary" is usually used in a financial context, although in other legal contexts it can have other meanings, such as a legal guardian caring for a minor. In broad terms, when someone has a "fiduciary responsibility," that person is responsible for acting to benefit the principals or beneficiaries. The most common example of a fiduciary is a trustee that holds assets for a beneficiary or beneficiaries under a trust arrangement.

A fiduciary is held to a high standard of conduct and trust. A fiduciary must take the same care in managing the assets or the authorities as if they belonged to the fiduciary and must avoid conflicts of interest.

A fiduciary is expected to make full disclosure of all material facts to the principals or beneficiaries. A breach of fiduciary duty can occur if the fiduciary acts in his, her, or its own self-interest or the interest of anyone other than the principals or beneficiaries or fails to disclose material facts to the principals or beneficiaries.

A fiduciary usually is a professional with greater skills than ordinary people. Accountants, attorneys, auditors, and other professionals that serve as fiduciaries are expected to use their expertise in acting on behalf of those to whom they provide fiduciary services.

Accountants and auditors provide fiduciary services to multiple stakeholders and to society, such as:

- The party paying the accountant's or auditor's fee or salary
- The current owner(s) or shareholder(s) of the firm
- Potential future owner(s) or shareholder(s)
- Employees
- Governments as taxing authorities
- Lenders and other creditors, such as suppliers who offer terms
- Potential future lenders and other creditors
- The SEC, for a company that reports to the SEC
- The public at large

Professional accountants and auditors undertake to maintain the trust inherent in the fiduciary relationship so that those relying on their expertise can trust that proper care is taken of their interests.

Because a professional accountant or auditor provides fiduciary services to so many different stakeholders, the performance of his or her services may at times involve choices that could favor the interests of one or

more of the stakeholders at the expense of the others. However, audited financial statements are intended to be fairly presented according to the perspectives of **all** the stakeholders. To narrow the range of acceptable choices, professional accountants and auditors are expected to adhere to Generally Accepted Accounting Principles and Generally Accepted Auditing Standards that have been created so that choices made according to them will be fair to all users of the resulting financial reports and audit reports. If audited financial statements are biased and favor one user group over the others, the fiduciary responsibility of the accountant or auditor will have been breached, which will negatively reflect on the reputation and credibility of the whole profession.

An accountant's or auditor's loyalty is due first to the public interest and then to the accounting profession, and it is fulfilled by observing the principles in the standards and in his or her professional code of conduct. Loyalty to the management of the organization should rank below loyalty to the public, to the accounting profession, to existing shareholders, and to the accounting or audit firm that may be employing the accountant or auditor.

Some clients or employers may think that a professional accountant or auditor has a contract with them and must act only in their best interest. However, the contract is one in which the professional is understood to be answerable first to the ethical codes of the profession, so no client or employer can expect absolute loyalty to themselves rather than to the profession and, ultimately, to the public.

Although professional accountants employed by organizations or audit firms have no statutory or contractual duty to shareholders or the public, they must exercise honesty, integrity, objectivity, and due care. A professional accountant cannot, therefore, be associated with a misrepresentation.

In its paragraph on *Resolving Ethical Issues*, the *IMA Statement of Ethical Professional Practice*, effective July 1, 2017, says, "If resolution efforts are not successful, the member may wish to consider disassociating from the organization."

Note: The primary duty of professional accountants and auditors is to ensure the accuracy and reliability of their work for the benefit of the public.

It is reasonable, however, for the client or employer to expect a professional accountant or auditor to place the client's or employer's interest before the professional's own self-interest. Legitimate confidences about business problems should be kept confidential because, for example, the interest of a client or employer could be undermined by premature release of information, or the information could be misused for personal gain. Therefore, the *IMA Statement of Ethical Professional Practice* and most other professional codes of conduct require that confidences not be divulged except in a court of law or when required by the discipline process of the profession.

Nevertheless, **maintaining confidentiality should not require a professional accountant to maintain silence if misrepresentation is taking place**. Unfortunately, some current ethics codes do require silence or confidentiality, thus leaving unsuspecting stakeholders such as lenders or shareholders to sustain losses because of relying on fraudulent financial statements when no one told them about the fraud.[106]

[106] Brooks and Dunn, 391-392.

Business Fraud

Business fraud is any intentional communication or action that deceives, manipulates, or conceals facts to provide the perpetrator with an unlawful financial gain and harm another or others. Fraud can be carried out by one person, a group of people, or a company. The ways in which fraud can be committed are limited only by perpetrators' imaginations, and new ways of committing fraud are being devised all the time, especially ways that make use of opportunities afforded by technology and technological change.

Fraud within a company may be committed by an employee or employees; by managers at all levels; and by top management, even originating with the CEO. Fraud can be a crime and can be prosecuted, and convictions can result in fines, imprisonment, or both.[107]

Some of the types of business fraud to be aware of include:

Asset misappropriation: A general definition of "asset misappropriation" is illegal possession of property that belongs to another entity by a person with a responsibility to care for and protect the property for the other entity. It can mean "borrowing" the property without permission, but it usually means stealing it. In general, it means any action that causes the company to expend cash for goods and services that do not benefit or provide value to the company. When it is committed by an employee, the employee is abusing their position, and it is employee or insider fraud.

Asset misappropriation includes cash theft, inventory theft and misuse, accounts receivable fraud, fraudulent disbursements and fake suppliers, expense reimbursement schemes, check tampering, and payroll fraud.

- **Cash theft**. Theft of cash may be theft of cash on hand or theft of cash receipts. Theft of cash on hand involves an employee stealing cash from a company's vault. Theft of cash receipts may involve an employee either not recording some cash sales at all or understating cash sales ("skimming") or theft of the cash after it has been recorded in the company's books.
- **Inventory theft and misuse**. Inventory misuse occurs when an employee makes personal use of the company's inventory. Even if the employee returns the inventory, it will have been used and its value diminished. Inventory theft can involve false sales and shipping, purchasing and receiving schemes, and outright theft. False sales involve an employee working with an accomplice who "buys" merchandise, but the employee does not record the sale and the accomplice receives the merchandise without making payment for it. False shipment occurs when an employee creates false sales documentation and shipping documents to make it appear that the stolen inventory was sold. Purchasing schemes are perpetrated by an employee with purchasing authority who uses that authority to purchase merchandise which may be directed to a different location that the employee controls. Receiving schemes involve an employee misappropriating assets purchased by the company as they are received. Outright theft occurs when an employee removes inventory from the company's premises without trying to conceal the theft in the accounting records.
- **Accounts receivable fraud**. Accounts receivable fraud can be committed as a write-off scheme in which an employee misappropriates cash receipts and writes off the associated receivables as credit losses, or the more involved lapping scheme. When lapping is being committed, an employee receiving a cash payment takes the money and does not record it as a receipt from that customer. Then, the same employee records another cash receipt from another customer as having come from the first customer, as of the date the first customer actually paid. In this manner, the employee is always "one receivable behind." In order to end the cycle, the employee uses a receipt from a single, one-time customer and applies it to the last receivable and then writes the one-time customer's receivable off as a credit loss. Because it was a one-time customer, the chances of the write-off being investigated are very small. The potential for lapping to take place can be minimized by having someone other than the person receiving cash approve the write-off of receivables.

[107] O. C. Ferrell, Fraedrich, and L. Ferrell, 71.

- **Vendor fraud, fraudulent disbursements, and fake suppliers**. Fraudulent disbursements occur when an employee causes a payment to be made from company funds for some inappropriate purpose. Fraudulent disbursements involve the cash leaving the company fraudulently, but the transaction is recorded in the accounting records and so there is an audit trail. The employee creates a fake supplier in the accounts payable system, perhaps using a stolen identity, and then submits fraudulent invoices, usually with a post office box address. If the employee has the authority to approve the invoice for payment or is colluding with someone else who does have the authority, this scheme can result in fraudulent disbursements being made to the fake supplier.

- **Expense reimbursement schemes.** Expense reimbursement schemes involve personnel, usually personnel in sales, who overstate or create fictitious expenses for travel and customer entertainment. The entertainment may have actually taken place and the employee may have the receipts to prove it, but the expenses were for personal entertainment and no customer was present. Or, an employee might simply create a receipt for something they never received and submit it for reimbursement.

- **Check tampering**. An employee may alter payee information on checks issued by the company to legitimate vendors so they can be deposited in an account that the employee controls. Check tampering could also involve the employee issuing false manually created checks. To address the potential for check tampering, blank check stock and signature stamps should be kept locked up and be accessible only to authorized persons. In another form of check tampering, an employee could intercept a company check and forge the payee's endorsement on the check to divert the funds to him- or herself. Or an employee with signature authority on the company's checking account could simply write fraudulent checks payable to him- or herself.

- **Payroll fraud**. Payroll fraud can take many different forms. It could involve creating a fake employee or employees in the payroll system and taking their paychecks. An employee with access to payroll data may increase their own wage rate or hours worked to increase their paycheck. An employee may inflate the number of hours they worked on the timesheet they turn in, or a worker may "clock in" for a co-worker who is not present.

Manipulation of financial statements: Manipulation of financial statements includes fraudulent financial reporting and other actions that may or may not rise to the level of illegality but are unethical even if not illegal. Those include (but are not limited to) aggressive accounting, earnings management, income smoothing, and loan-application fraud.

- **Fraudulent financial reporting** is intentional misstatements or omissions in financial statements performed with the intention of deceiving financial statement users.[108] If financial statements contain inaccurate information, whether intentional or not, lawsuits and criminal penalties may result. According to research, fraudulent financial reporting most often occurs due to pressure from the CEO rather than for the personal gain of the financial officer responsible.[109]

- **Aggressive accounting** is making intentional choices about application of accounting principles, whether in accordance with GAAP or not, not for the purpose of improving financial reporting but rather to achieve desired results such as higher current earnings.

- **Earnings management** is manipulation of earnings to meet a predetermined target that may have been set by management, or to meet a forecast by analysts, or to achieve an amount consistent with smoother, more sustainable earnings.

---

[108] Charles W. Mulford and Eugene E. Comiskey, *The Financial Numbers Game: Detecting Creative Accounting Practices* (John Wiley & Sons, Inc., 2002), 3.

[109] Mei Feng, Weili Ge, Shuqing Luo, and Terry Shevlin, "Why do CFOs become involved in material accounting manipulation" *Journal of Accounting and Economics* 51, 1-2 (2011): 21-36, referenced in O. C. Ferrell, Fraedrich, and L. Ferrell, 71.

- **Income smoothing** is a form of earnings management intended to remove peaks and valleys from periodic earnings. It includes the practice of reducing and "storing" profits during highly profitable periods and using them during slower years.[110]
- **Loan-application fraud** is making false statements on financial reports to obtain credit or maintain existing credit approvals for a business, such as presenting fraudulent financial statements that falsify net income and inflate the value of inventory, real property, or other assets.[111]

Marketing fraud. Marketing fraud is dishonestly creating, promoting, pricing, and selling products. Marketing fraud can involve false and deceptive advertising, exaggerated claims, concealed facts, or outright lying. An example of deceptive advertising is advertisements that are not clearly labeled as advertisements but are disguised to look like news stories. False advertising includes puffery, implied falsity, literal falsity, and making ambiguous statements.

- **Puffery** is exaggerated advertising claims such as claiming to be the best.
- **Implied falsity** is a message that misleads, confuses, or deceives the public. An example of implied falsity is a claim that is literally true but implies something else that is false, such as saying a product has twice as much of an ingredient when the extra quantity of the ingredient does nothing to improve the product's performance.
- **Literal falsity** involves, for example, citing a study or test in making a claim when the study or test does not support the claim; or making false assertions about the product such as saying it is "all natural" when it contains some artificial ingredients.
- **Ambiguous statements** use words that are so vague and non-specific that the receiver of the statement must infer the intended message. Because the statements are so vague, the advertiser can deny any intent to deceive. Examples are phrases that use the word "help": saying that the product "helps prevent," "helps fight," or "helps you feel better." Statements such as those may be viewed as unethical because they do not provide all the information consumers need to make a good purchasing decision, and they may deceive the consumer outright.

Consumer fraud occurs when a consumer attempts to deceive a business to gain an unfair economic advantage over the business. Just a few examples of ways in which consumers can commit consumer fraud are friendly fraud, price arbitrage, return fraud, wardrobing, and returning stolen goods.

- **Friendly fraud** involves making a big purchase and paying for it to be shipped in fulfillment; then after receiving it, claiming it was never received and requesting a refund.
- **Price arbitrage** is requesting a refund for a returned item, when the item actually returned is a lower-priced but similar item to the one purchased.
- **Return fraud** is requesting a refund for a returned item, but instead of returning the item, replacing it in its box with something different such as rocks, sealing the box, and shipping it back. If the store employee who receives it does not check inside the box, the customer may receive a full refund.
- **Wardrobing** is purchasing an expensive item of clothing and wearing it once for an event, then attempting to return it for a full refund.
- **Returning stolen goods** involves first stealing something from a store, then "returning" it to the store for a refund.

---

[110] Mulford and Comiskey, 3.

[111] O. C. Ferrell, Fraedrich, and L. Ferrell, 71.

Financial misconduct can occur when members of the financial industry take inappropriate risks that cause problems for the whole economy. An example was the subprime mortgage lending crisis of several years ago, when loan officers were receiving commissions on loans initiated with no provision to take back the commissions if the borrower later defaulted on the loan. As a result, some loan officers encouraged subprime borrowers to make false statements on their loan applications to secure loans they were not qualified for and encouraged appraisers to appraise homes at inflated values to support the increased loan amounts. As a result, home values increased rapidly, driven by the excess demand from buyers who in another time would never have been able to qualify for mortgage loans that large. When the borrowers began defaulting on the loans, home values declined and homeowners found themselves with homes on which the mortgage balances were well in excess of the homes' market values. Many of them just walked away from the homes, leaving the lenders to repossess the homes and take losses because the homes' market values were so much lower than the balances of the mortgage loans on them.[112] Many lending institutions became insolvent as a result. The Federal Reserve had to prop up many of them with loans and even equity infusions; and many were taken over by the FDIC and were merged with other financial institutions with FDIC assistance.

Financial misconduct can also include fake investment schemes, most often perpetrated by someone operating a **Ponzi scheme**. A Ponzi scheme lures investors with promises of high investment returns. But instead of earning legitimate returns for the investors, the perpetrator steals the funds and pays so-called "returns" to earlier investors using funds invested by more recent investors. As long as new investors keep giving the perpetrator their money and investors do not demand repayment, the scheme can continue. But when new money dries up and investors want to withdraw their funds, the scheme is exposed because the funds are not there. The scheme collapses, and most of the investors lose their money.

Intellectual property infringement is the violation of someone else's right to intellectual property that they developed. Intellectual property infringement may include copyright infringement, patent infringement, trademark infringement, or design infringement.[113] Intellectual property infringement can cause a company to lose profits and its reputation, and it can also threaten the well-being of consumers. As an example, illegally produced medications masquerading as the real thing may contain no medication at all or may contain ingredients that injure consumers, causing illness and even death.[114]

Espionage includes the theft of proprietary information, which could also be considered intellectual property infringement, and the manipulation of IT systems.

Corruption includes illegal gratuities, bribes, kickbacks, conflicts of interest in business dealings, or economic extortion.

Other types of business fraud include merchandise not shipped after it has been paid for; merchandise not paid for after it has been delivered; fake charity fraud, in which people are made to believe they are donating to a charity when the charity does not exist and the perpetrator keeps the money received; identity theft; and counterfeiting of money and documents.

---

[112] O.C. Ferrell, Fraedrich, and L. Ferrell, 71-76.

[113] "Intellectual Property Infringement," Wikipedia, https://en.wikipedia.org/wiki/Intellectual_property_infringement, accessed July 17, 2023.

[114] O.C. Ferrell, Fraedrich, and L. Ferrell, 77.

Study Unit 38: E.2. Ethical Considerations for Accountants in Business

Customs and traditions in different parts of the world, and even in neighboring countries, make ethics a complicated issue. What may be considered unethical in one part of the world may be seen as "business as usual" in another part. Despite these local and regional elements of ethics, there is a shared understanding of what is considered ethical or unethical on a global level.

The FMAA exam tests ethics based on the standard established by the Institute of Management Accountants and codified in its *Statement of Ethical Professional Practice*.

IMA Statement of Ethical Professional Practice

Individuals in management accounting and financial management have a unique set of circumstances relating to their employment. To address the issue of ethics for its members and to help them assess a situation when they need to make a decision, the Institute of Management Accountants (IMA) has developed a Code of Ethics, called *IMA Statement of Ethical Professional Practice*. The Statement, adopted in its current form in July 2017, is provided here in full.

Adherence to the principles and standards in the *IMA Statement of Ethical Professional Practice*, both domestically and internationally, is integral to achieving the objectives of management accounting. IMA members shall not commit acts contrary to these principles and standards nor shall they condone the commission of such acts by others within their organizations.

It is highly recommended that candidates taking the exam read the *IMA Statement of Ethical Professional Practice* carefully, know its contents thoroughly, and be able to apply it to a variety of situations. Candidates should also be able to **cite**, **quote**, and **define** any applicable principle or standard, even though the principles and standards are not defined in the Statement. For the exam, passages from the *IMA Statement of Ethical Professional Practice* should be quoted word for word in responding to an essay question. Paraphrasing is not sufficient, so memorization is essential.

Candidates should know which attributes of ethical behavior are **principles** and which are **standards**. Principles and standards sometimes overlap, and similar examples may be given for more than one principle or standard. Similar examples arise because a given behavior may exemplify more than one principle or standard.

For instance, the standard of **competence** is the quality of having the required skill, knowledge, qualifications, and capacity to fulfill a particular job effectively. The standard of **credibility** is the quality of being believable and trustworthy, which requires maintaining competence, which in turn means having the required skill, knowledge, qualifications, and capacity to fulfill a job effectively. Therefore, if credibility is an issue in a situation, then competence may also be an issue, and both should be cited. Candidates should understand these similarities between and among the various principles and standards.

Note: Candidates should make sure to know which are the principles and which are the standards, as an exam question may require them to be identified as either principles or standards.

In the *IMA Statement of Ethical Professional Practice* that follows, explanatory notes in the shaded boxes follow the principles and standards including definitions of the principles and standards. These definitions and explanatory notes were added by HOCK and are **not** part of the *IMA Statement of Ethical Professional Practice*.

Note: It is strongly recommended that exam takers **memorize** the *IMA Statement of Ethical Professional Practice*, which is reproduced on the following pages. In addition, candidates must absolutely **understand** these tenets and be able to apply them to various situations.

IMA Statement of Ethical Professional Practice[115]

Members of IMA shall behave ethically. A commitment to ethical professional practice includes overarching principles that express our values and standards that guide member conduct.

PRINCIPLES

IMA's overarching ethical principles include Honesty, Fairness, Objectivity, and Responsibility. Members shall act in accordance with these principles and shall encourage others within their organizations to adhere to them.

Note: IMA's basic ethical principles are **Honesty**, **Fairness**, **Objectivity**, and **Responsibility**. An answer to an essay question involving IMA's ethical principles must both **list them** and **define them**. The definitions, which are not part of the Statement, are:

Honesty means truthfulness or trustworthiness. Being honest means telling the truth to the best of your knowledge. It is the quality of being upright, having sincerity, frankness, and freedom from deceit or fraud.

Fairness means acting in an impartial manner and being free from bias, dishonesty, or injustice. It requires a person to be just, equitable, and impartial.

Objectivity means basing a judgment on an established set of criteria. It is the state of being unbiased, free from personal feelings or prejudice and basing analyses and decisions on the facts alone.

Responsibility means performing an act or a function completely and in a timely manner. It is the state of being answerable or accountable for something that is within one's own power, control, or management.

STANDARDS

IMA members have a responsibility to comply with and uphold the standards of Competence, Confidentiality, Integrity, and Credibility. Failure to comply may result in disciplinary action.

I. COMPETENCE

1) Maintain an appropriate level of professional leadership and expertise by enhancing knowledge and skills.
2) Perform professional duties in accordance with relevant laws, regulations, and technical standards.
3) Provide decision support information and recommendations that are accurate, clear, concise, and timely. Recognize and help manage risk.

Note: **Competence** means the quality of having the required skill, knowledge, qualifications, and capacity to fulfill a particular job effectively. Every level of responsibility has its own requirements, and competence can and should occur at all stages of a person's career. Competence in one position does not automatically mean that the person will be competent in a different position.

Fulfilling the competence standard includes but is not limited to keeping up with changes in laws, regulations, accounting standards, and association rules and requirements. Some examples of these are:

- New guidance issued by the PCAOB and the SEC relating to requirements in the Sarbanes-Oxley Act.
- New and revised Generally Accepted Accounting Principles (GAAP), including U.S. standards issued by the Financial Accounting Standards Board (FASB) and/or International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), as appropriate.
- Other national and state legislation specific to the applicable industry or applicable to all firms.

Failure to keep informed about changes in these regulations could cause an individual to unknowingly violate a legal requirement and/or commit an ethics violation.

[115] Institute of Management Accountants, © 2017 Institute of Management Accountants, used by permission.

II. Confidentiality

1) Keep information confidential except when disclosure is authorized or legally required.

2) Inform all relevant parties regarding appropriate use of confidential information. Monitor to ensure compliance.

3) Refrain from using confidential information for unethical or illegal advantage.

Note: **Confidentiality** means safeguarding information and not disclosing anything to those who are not authorized to know it. The following are some examples of ways to keep information confidential:

- Refrain from discussing confidential information in any public setting since the conversation could be overheard.
- Be aware of who in the organization has authorized access to confidential information and who does not.
- Make sure that subordinates handle confidential information in an appropriate manner.
- Refrain from discussing confidential information with family or friends.
- Use robust and rotating passwords to protect documents and set permissions so that only authorized people can access them.
- Protect laptop computers, especially when they are removed from company premises.
- Avoid connecting to the Internet using an insecure or public connection.
- Permanently delete or otherwise destroy documents that are no longer needed.
- Be familiar with company guidelines and legal standards regarding information disclosure.

Confidential information can be disclosed in ways other than by stating it, by innuendoes or even by just making a facial expression or gesture. Be careful not to disclose confidential information in this manner.

III. Integrity

1) Mitigate actual conflicts of interest. Regularly communicate with business associates to avoid apparent conflicts of interest. Advise all parties of any potential conflicts of interest.

2) Refrain from engaging in any conduct that would prejudice carrying out duties ethically.

3) Abstain from engaging in or supporting any activity that might discredit the profession.

4) Contribute to a positive ethical culture and place integrity of the profession above personal interests.

Note: **Integrity** involves adhering firmly to a code of ethics. The actions of persons or firms that have integrity are consistent with their principles and values. A person who refuses to make compromises in matters of principle has integrity. A firm with integrity does not compromise its core values. Below are some suggestions for maintaining personal integrity:

- Reject gifts, favors, or anything else designed to influence behavior or imply a future obligation.
- Conflicts of interest in a situation must be avoided. A person who has a conflict of interest in a situation should recuse (remove) himself or herself from any decision-making position or any position of influence related to the situation. A conflict of interest is a situation in which a public official, business executive, or other individual in a position of trust might receive personal gain for him- or herself or for a friend or family member from his or her official or professional actions.
- Communicate both good and bad news to superiors.

An organization's integrity is based on the organization's values and on an unwillingness to deviate from standards set by the firm and the industry.

- Businesses should follow all applicable laws and regulations.
- Businesses should not knowingly cause harm to customers, clients, employees, or competitors by deceiving them, misrepresenting their products or services, or practicing coercion. Not causing harm to customers includes not distributing a product or providing a service that can cause physical or other harm.

IV. Credibility

1) Communicate information fairly and objectively.
2) Provide all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.
3) Report any delays or deficiencies in information, timeliness, processing, or internal controls in conformance with organization policy and/or applicable law.
4) Communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.

Note: **Credibility** is the quality of being believable and trustworthy. Credibility involves:

- Maintaining competence, possessing current knowledge about the profession, and keeping up to date on changes that affect given responsibilities.
- Providing regular updates on projects.
- Presenting bad news in a timely manner without omitting any pertinent information.
- Disclosing to management any professional limitations or other constraints that could impair the performance of duties.
- If it will not be possible to perform a task as expected, letting everyone concerned know as soon as possible.
- Gathering all necessary facts and conducting thorough analysis.
- Being prepared for risks by assessing risks ahead of time.

Resolving Ethical Issues

In applying the Standards of Ethical Professional Practice, the member may encounter unethical issues or behavior. In these situations, the member should not ignore them, but rather should actively seek resolution of the issue. In determining which steps to follow, the member should consider all risks involved and whether protections exist against retaliation.

When faced with unethical issues, the member should follow the established policies of his or her organization, including use of an anonymous reporting system if available.

If the organization does not have established policies, the member should consider the following courses of action:

- The resolution process could include a discussion with the member's immediate supervisor. If the supervisor appears to be involved, the issue could be presented to the next level of management.
- IMA offers an anonymous helpline that the member may call to request how key elements of the *IMA Statement of Ethical Professional Practice* could be applied to the ethical issue.
- The member should consider consulting his or her own attorney to learn of any legal obligations, rights, and risks concerning the issue.

If resolution efforts are not successful, the member may wish to consider dissociating from the organization.

Source: Institute of Management Accountants, © 2017 Institute of Management Accountants, used by permission.

Employee Fraud and the Fraud Triangle

In *Other People's Money*, Donald R. Cressey developed a theory for why employees embezzle. His theory, which has become known as the **Fraud Triangle**, identifies three conditions that must be present for a trusted employee, usually a long-term employee, to commit a fraudulent act against his or her employer. These three conditions are called the three legs of the "fraud chair":

1) **Pressure**. The employee has a financial problem—such as addiction, bills, or excessively high company earnings expectations or sales targets—that cannot be shared and cannot be solved through legitimate means.

2) **Opportunity**. The employee sees a way to use a position of trust with an employer to solve the problem in secret and believes it can be done in such a way that there will be a low risk of getting caught.

3) **Rationalization**. The employee needs to be able to justify the crime as an acceptable or justifiable act. Such rationalization may require the employee to engage in convoluted, contradictory, and morally suspect leaps of logic to defend an illegal or immoral act. For example, the employee may think "I am just borrowing the money and I will put it back," "I am being underpaid, and my employer owes this to me," "the amount I'm taking is not significant enough for management to care about," or "my employer is dishonest to others and deserves to get dishonesty back."

Cressey notes that an employer can reduce the chances of fraudulent activity by cutting off at least one leg of the "fraud chair."

1) Employees should be made to feel that they can come to their employer about financial or other problems without being judged, and the employer will help them.

2) The employer should provide a means for employees to air grievances.

3) Employers should set a moral and ethical "tone at the top" by projecting and engaging in honest behavior to prevent employee rationalization that since the employer is dishonest, they need not be honest. When executives are "cooking the books" or seeking ways around internal controls, employees get the message that dishonesty is acceptable.

4) An employee hotline, mandated under Sarbanes-Oxley, gives employees the opportunity to let management know about suspected wrongdoing. The very existence of a hotline can serve as a fraud deterrent because any employee considering committing fraud would be aware of a readily available means for the fraud to be reported.

5) Management should design and implement a control environment that prevents, detects, and deters most fraudulent behavior. In doing so, management undermines the opportunity for illegal behavior by limiting opportunity. The control environment should include:

   - An independent and empowered Audit Committee of the Board of Directors that understands the company's fraud risk exposure and that evaluates and monitors the company's controls.
   - An annual risk assessment identifying specific fraud risks that can be used to identify key controls designed to address the risks.
   - A hotline available to vendors and customers as well as employees because fraud can include activities such as bribery and corruption.
   - A written anti-fraud policy that clearly defines fraud and improper conduct and employee training sessions to review the policy and the importance of ethical behavior.
   - A written policy regarding the way fraud allegations are investigated and resolved.

